INDEX	1st Quarter, 2015	Last 12-Months
US STOCKS		
S&P 500 Index (large-cap stocks)	0.95	12.73
Russell 2000 Index (small-cap stocks)	4.32	8.21
FOREIGN STOCKS		
MSCI EAFE Index (developed foreign markets)	4.88	(0.92)
MSCI Emerging Markets Index	2.24	0.44
MSCI BRIC Index (Brazil, Russia, India, China)	3.55	3.61
COMMODITIES		
US Dollar Index	8.96	22.79
Gold Spot $/oz.	(1.02)	(8.11)
Silver Spot $/oz.	3.94	(16.88)
WTI Crude Oil	(13.39)	(47.95)
BONDS		
BarCap US Aggregate Bond (investment-grade bonds)	1.61	5.72
BarCap US 20+ Yr Treas Bd Idx (long-term US treas)	4.16	22.65
Barclays Municipal Bond Total Return Index	0.93	6.35
Barclays US Credit Bond Index (corporate bonds)	2.16	6.74
Barclays US Corp. High Yield	2.12	1.75
S&P/Citi Intern'l Treas Bond Ex-US (foreign bonds)	(4.99)	(10.17)

Source: iShares.com & Bloomberg

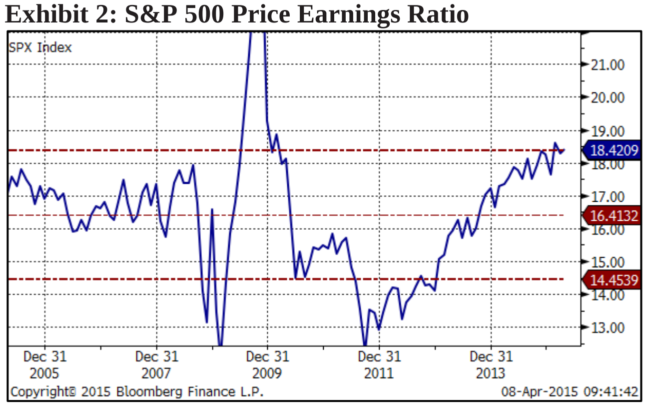
On balance, it was another good quarter for investors as the bull market reached its six-year anniversary in March. US stocks and bonds were positive, and foreign stocks posted relatively strong returns after underperforming the US stock market for a number of years (Exhibit 1). Oil was down, again, but appears to be stabilizing.

Exhibit 1: Foreign Stocks *relative* to US Stocks*

**MSCI EAFE return relative to S&P 500*
Source: Bloomberg

Overall, we're maintaining a cautious near-term outlook as valuations within the US stock market continue to appear stretched (Exhibit 2) and the Fed seemingly intent on raising short-term interest rates in September. With that said, the outlook is far from ominous with no imminent recession, inflation or *major* interest rate hike cycle on the horizon. In general, we are at neutral equity allocations (neither over-weight nor under-weight) with a slight underweight in foreign stocks. We are maintaining our allocation to high quality fixed-income as an important hedge against what we believe is a reasonable likelihood of a correction in the months ahead.

Exhibit 2: S&P 500 Price Earnings Ratio



Source: Bloomberg

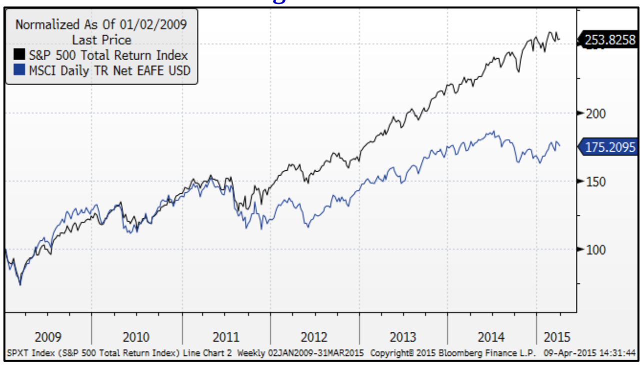
From our perspective, the most significant macro development during the first-quarter was the European Central Bank's (ECB) announcement of its commitment to a quantitative easing program worth at least 1.1 trillion euros (US $1.3 trillion) on January 22. The ECB pledged to buy 60 billion euros every month through September, 2016. We believe this, along with of other factors are combining to shift the outlook for stock returns in favor of foreign markets (particularly those in the euro area) relative to the US, and much of this letter is devoted to explaining why.

STOCK MARKET DYNAMICS

US stocks have been stand out leaders, returning 254% (S&P 500), compared to 175% for non-US stocks (MSCI EAFE) since the end of 2008 (Exhibit 3). That is likely to change as the prospects for US stocks weaken, while the outlook for their foreign counterparts has improved.

From a monetary policy perspective, the argument for a more positive outlook toward foreign stocks is straight forward. While the Fed is preparing to raise short-term interest rates, most other central banks continue to ease monetary policy. As Exhibit 4 illustrates, US stocks tend to perform poorly in the period following the first rate hike whereas quantitative easing (currently underway in the euro zone and in Japan) has proven to be a strong tailwind for risk assets.

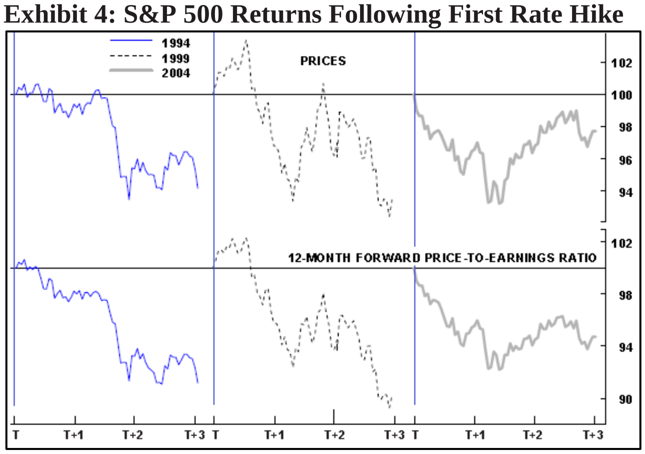
Exhibit 3: US and Foreign Stock Market Returns



Source: Bloomberg

In the US, corporate earnings growth is slowing. S&P 500 earnings per share (EPS) growth for the prior 12-months was 10.7% at the end of the first-quarter, 2014. It now stands at 3.3%. EPS estimates for 2015 have fallen from $136 last October to $119 today, the swiftest decline since the financial crisis.

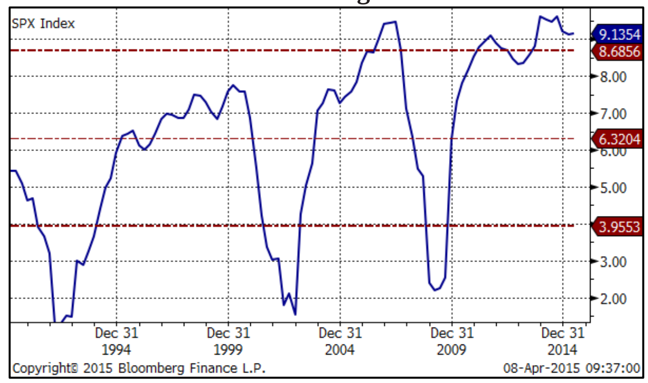
Exhibit 4: S&P 500 Returns Following First Rate Hike



Source: BCA Research

With foreign revenues accounting for over a third of S&P 500 sales, it is not surprising that the stronger dollar has weighed on earnings as foreign profits are translated back into dollars at less favorable exchange rates and US exports become less competitive. Generally speaking, a 10% appreciation in the broad trade-weighted dollar tends to reduce earnings per share for the S&P 500 by around 2.5%. At this point, the dollar has risen by 15% since last summer. All of this at a time when profit margins – a key driver of corporate earnings growth – are already at all-time highs (Exhibit 5) and unlikely to expand much further.

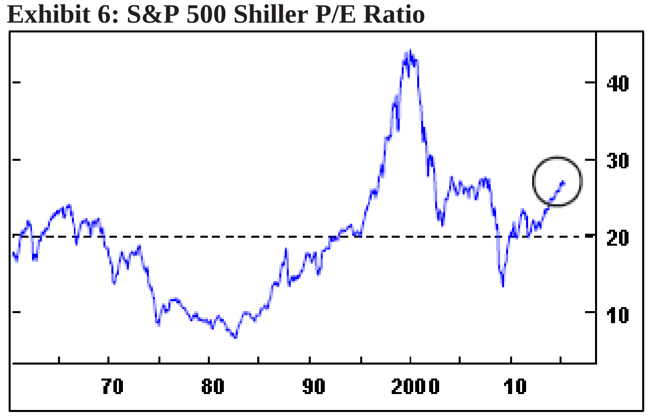
Exhibit 5: S&P 500 Profit Margins



Source: Bloomberg

None of this would be insurmountable if US stocks were cheap, but they're not. For instance, the Shiller price/earnings ratio – which uses the average of earnings over the prior 10 years – currently stands at 27 (Exhibit 6). This is 34% higher than the post-1960 median. And, the earnings component of this measure is being "flattered" by record high profit margins. In other words, if margins weaken, valuations will look even more unattractive than they do today.

Exhibit 6: S&P 500 Shiller P/E Ratio



Source: BCA Research

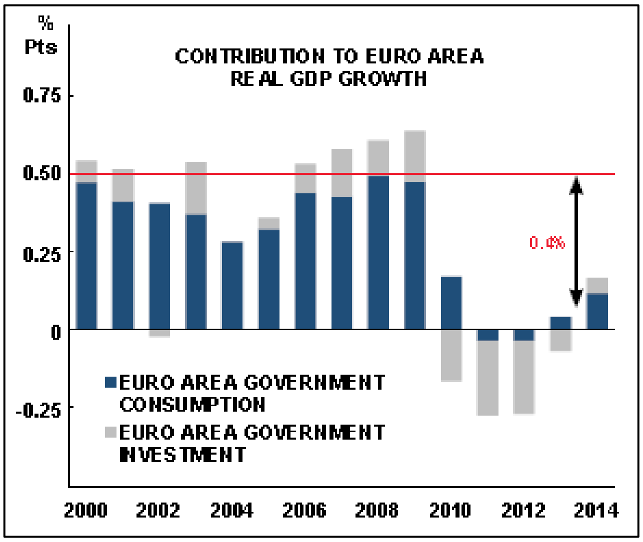
Euro area equities, on the other hand, appear have entered a 'Goldilocks' phase. Profit margins in the euro area are currently only half of what they are in the US and therefore have much more potential upside leading to earnings growth that is likely to outpace that of the US. Consensus analyst estimates currently point in that direction: while EPS for US companies is expected to grow by just 1.8% in 2015, EPS in the euro area is expected to rise by 14.5%.

In addition to the quantitative easing mentioned earlier, four economic forces are coming together that should lift euro area growth over the next few years to a level well above the current consensus estimates of 1.3% for 2015 and 1.6% for 2016.

1. Diminished Fiscal Drag

The budget balance in the euro area has improved significantly since 2010. Given the improvement, the need for additional austerity measures has diminished. As a consequence, the contribution of government spending to real GDP growth in the euro area should increase significantly (Exhibit 7).

Exhibit 7: Euro Area Government Spend Should Normalize



Source: BCA Research

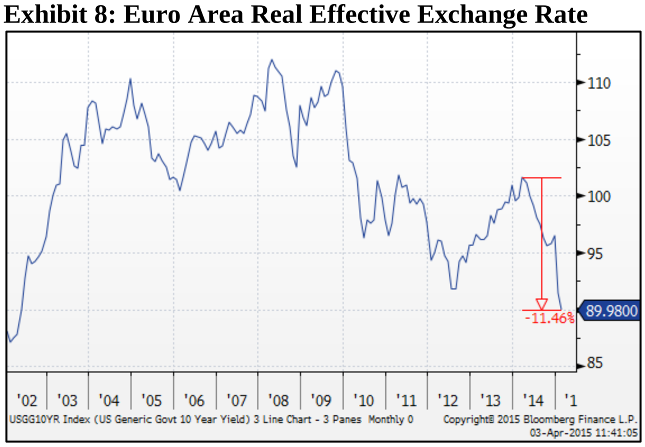
2. Lower Oil Prices

The IMF estimates that lower oil prices will boost euro area GDP by around 0.9% relative to a baseline where oil prices stayed elevated.

3. Weaker Euro

The real trade-weighted value of the euro has declined by more than 10% since last March taking it to the lowest levels since 2002 (Exhibit 8). Econometric estimates suggest that the depreciation of the euro should add approximately 0.6% to real GDP over the next two years.

Exhibit 8: Euro Area Real Effective Exchange Rate



Source: Bloomberg & Bank of International Settlements

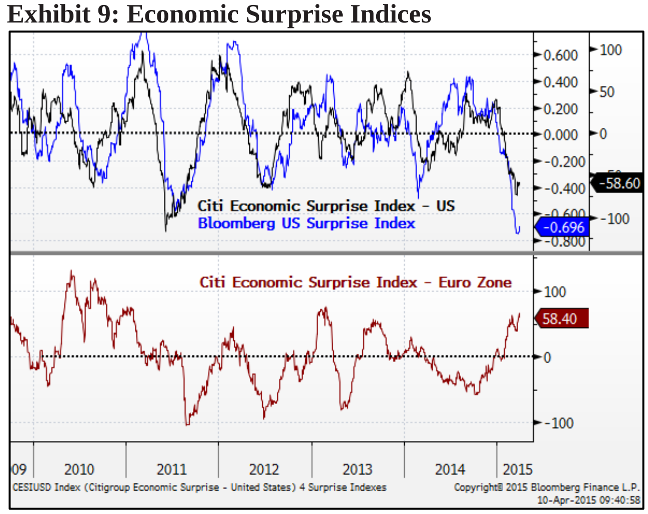
4. Easing of Deleveraging Pressures

The flow of credit to the private sector is picking up. This is partly because borrowing costs (interest rates) have declined sharply, but also because the lack of lending over the last few years has generated pent up demand for new borrowing.

If we assume credit grows at 3% (roughly in line with income growth), this should generate a positive credit impulse in excess of anything observed in the euro's 15-year history. This alone should boost GDP growth by at least 1% over the next year.

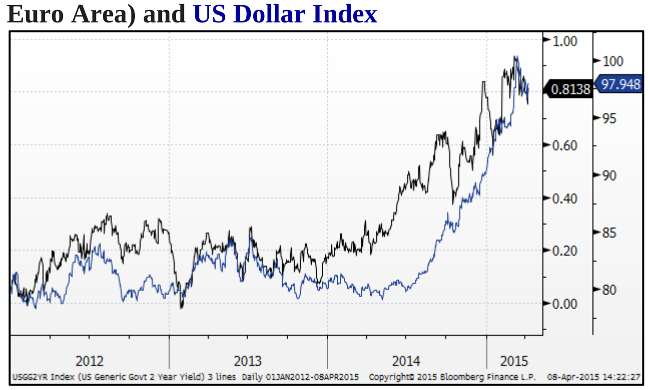
The tide indeed seems to be turning based on economic data so far this year. Surprises in the euro zone have been strongly positive during 2015 while the reverse is true for the US (Exhibit 9). Euro area stocks have, in turn, delivered strong returns in euro terms during the first quarter (17.8% as measured by the Euro Stoxx 50 index), but returns were more muted in US dollar terms (4.6%). This headwind to US investor returns from euro area stocks may be easing.

Exhibit 9: Economic Surprise Indices



On the surface, recent dollar strength has a simple explanation: while the Fed is preparing markets for higher short-term interest rates, other central banks are in easing mode. Exhibit 10 shows that the differential in two-year yields between the US and the euro area has closely tracked the trade-weighted dollar.

Exhibit 10: 2-Year Interest Rate Differential (US minus Euro Area) and US Dollar Index



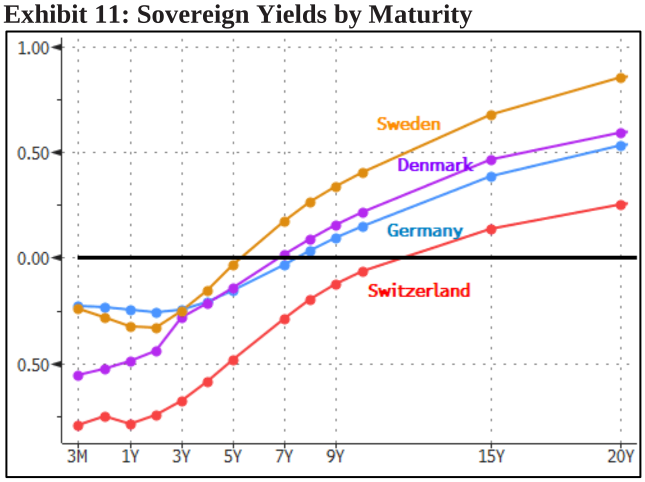
Source: Bloomberg

If this were the entire story, the dollar should continue to strengthen as the divergence in interest rates between the US and most other economies is expected to persist well into the future. However, we have to consider the selflimiting dynamic of how strong the dollar can get. If the dollar continues to strengthen, the US economy will weaken further causing the Fed to back off. The Fed's own estimates imply that the dollar's strength since last summer has tightened monetary conditions by the equivalent of around 1.0% to 1.5%. With this in mind, we believe the majority of the dollar's ascent versus the euro is behind us.

INTEREST RATES

A longtime assumption is that interest rates could not fall below zero, but this assumption is now being challenged with the European Central Bank, Switzerland, Denmark and Sweden all having cut interest rates they charge banks on excess deposits into negative territory (-0.20%, -1.25%, -0.75% and -0.85%, respectively). This decline in policy rates has pushed bond yields in the same direction. Exhibit 11 shows that Swiss government bond yields are negative out to 10 years, German yields out to seven, Danish yields out to six, and Swedish out to five.

Exhibit 11: Sovereign Yields by Maturity



Source: Bloomberg

People tend to hold "risk-free" government bonds because they want to avoid incurring any losses on their investment. Once interest rates become negative, losses become assured. This suggests that the descent of interest rates into negative territory could generate a strong reaction from investors.

In particular, it seems likely that euro area banks will become much more eager to expand credit to avoid paying interest on excess reserves. Likewise, if banks try to pass along the costs to depositors, savers may become much more inclined to spend in order to avoid seeing their account balances decline in the face of negative rates. Ultimately, the effect of a move to negative rates could prove to be very stimulative to economic activity. This strengthens our view that euro area growth will surprise on the upside over the next few years.

There are a number of additional implications:

- The downward pressure on euro area interest rates could intensify as ECB bond buying progresses.
- The fact that a number of European countries have been able to push interest rates into negative territory may entice others to follow suit.
- The desire to avoid buying bonds with a negative yield will push investors into whatever remaining bond markets still offer a *relatively* decent yield. As a result, US Treasuries yields could continue declining (Exhibit 12).
- Corporate bonds should see increased demand.
- Negative yields should provide additional support for euro area stocks. Given investor "home-bias", euro area stocks should be direct beneficiaries of European investors as they shift out of negative-yielding debt. The fact that euro area stocks sport a healthy dividend yield of around 3% should only help matters.

Exhibit 12: 10-Year US Treasury Note Yield

Source: Bloomberg

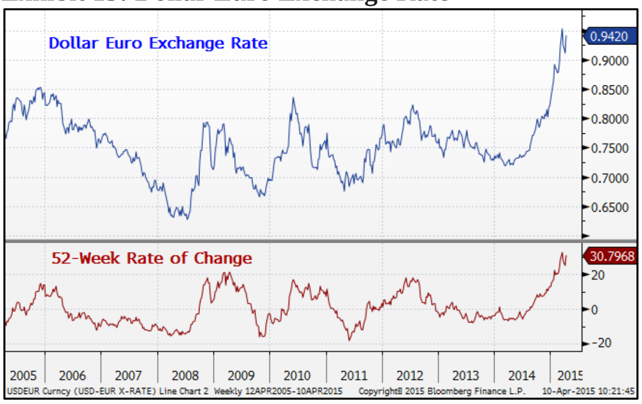
INVESTMENT STRATEGY

Stocks have had a good run over the last several years, and a "breather" is long overdue. It has been three years and six months since the S&P 500 corrected by at least 10%. This has happened only twice previously since 1932.

Still, with interest rates at very low levels and few signs of a significant slowdown in the largest developed economies, we are optimistic about returns over the cyclical horizon. That said, some fine tuning in regional weightings is in order. Relative valuations for US stocks have reached stretched levels and profit margins are coming under increased pressure. And, unlike other central banks, the Fed continues to signal its intension to raise interest rates later this year. With valuations, earnings momentum and financial conditions favoring non-US markets, we believe it's time to look abroad. The euro area, in particular, strikes us as the best source of potential outsized returns. We anticipate boosting portfolio exposure to the region now that it appears the dollar rally versus the euro is likely to slow (Exhibit 13) and, therefore, become less of a headwind to returns.

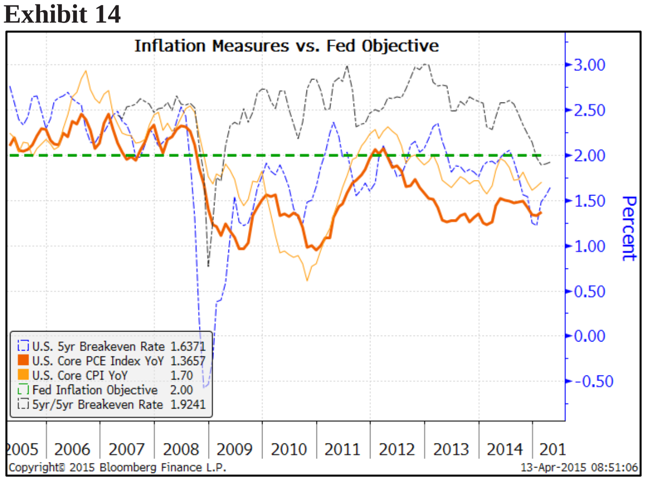
Within fixed-income, we continue to emphasize intermediate-term high quality bonds, with some exposure to high-yield. The key drivers have not changed: the combination of global policy stimulus and low odds of an inflation scare (Exhibit 14) should keep bond yields low even though the US Fed is itching to hike short-term rates. High-yield bonds should provide reasonable returns as the economy stays out of recession and investors seek out income. However, should growth weaken or a meaningful setback in risk assets occur, high-quality bonds will hedge against weakness in high-yield bonds, which in turn will offer better returns than stocks.

Exhibit 13: Dollar Euro Exchange Rate



Source: Bloomberg

Exhibit 14



Source: Bloomberg

-Brant Kairies
952-885-2732

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